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# Scaling the Costs of 404 Testing to Fit the Needs of Small Public Companies

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**Scaling the Costs of 404 Testing to Fit the Needs of Small Public Companies**

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## **Scaling the Costs of 404 Testing to Fit the Needs of Small Public Companies**

### **Abstract**

In July of 2002, the Sarbanes-Oxley Act was passed by Congress, including section 404 which requires the auditors to test and opine on the company's internal controls. Since that time there has been much debate about whether the intended benefits of increased investor confidence and financial statement transparency trump the unexpectedly high compliance costs, especially for public companies with market-caps less than \$75 million. Before these companies begin complying in the upcoming year, interest groups are calling for the requirements to be 'scaled' to better fit the needs of these companies. While auditors already are expected to scale their audit approach to each individual client, more must be done to significantly decrease the costs in order to reverse the trend of small companies foregoing listing on U.S. capital markets. Increased guidance from the PCAOB, SEC, and other related parties could help the small-cap companies and their auditors be aware of best practices. Also, exempting industries that already follow similar guidelines or are significantly injured by the compliance requirements could help. Lastly, the controversial proposal of rotational audits could be put in place if the affected parties cooperate to remove the undue burden on these small-cap companies. Without some form of significant action, the investors could soon lose the ability to buy small-cap companies in U.S. markets.

## **1.0 Introduction**

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With the passing of the Sarbanes Oxley Act in 2002, auditors are now obligated to test and opine on the internal controls of publicly-traded clients. While this was by no means the only change to the auditing environment under the Act, it has certainly been one of the most contentious. The process involved in satisfying the section 404 requirements has added huge costs in terms of capital and human resources to every public company audit without exception. However, these requirements are yet to be applied to audits of “non-accelerated filers,” or public companies with a market capitalization less than \$75 million dollars. The reason for this exemption is that implementing section 404 testing in small-company environments creates an exponentially higher cost than it does in large-company environments. In 2004, large corporations, defined as companies with net income greater than \$5 billion, spent .06% of their revenues on Sarbanes-Oxley related compliance, while voluntary non-accelerated filers spent 2.55%<sup>1</sup>. This undue burden on small-cap companies, who by nature have less capital, human resources, and experience than large corporations, has clearly had a detrimental affect on them, and arguably had a negative effect on US capital markets and the economy as a whole<sup>2</sup>.

Borne from this inequity is the idea of ‘scaling,’ or custom-fitting 404 testing requirements, so the burden would be on par with that experienced by accelerated filers. While the SEC has started down the correct path by issuing guidance<sup>3</sup> on how to appropriately satisfy SOX requirements in a capital and labor-efficient manner, this is only a minor part in the scaling process. Numerous advocacy groups, including the

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<sup>1</sup> “SOX 404: The Section of Unintended Consequences and its Impact on Small Business.” AEA, 2/05

<sup>2</sup> “SOX and the Flow of International Listings” J. Piotroski and S. Srinivasan, 4/07

<sup>3</sup> “Management’s Report on Internal Control Over Financial Reporting” SEC, 12/20/06

American Electronics Association, the International Association of Small Broker Dealers and Advisors, and the Silicon Valley Leadership Group have all issued their own comments on how to most appropriately apply section 404 to non-accelerated filers. Not surprisingly, they all take a relatively extreme approach, suggesting that the requirements never be applied, or at least not until a much more cost effective version is released. However, SEC Chairman Christopher Cox has nixed the idea of exempting small public companies by saying "...there should not be a second tier of integrity of a company's internal controls<sup>4</sup>." The idea of not applying section 404 to non-accelerated filers was also downplayed by others, such as PCAOB member Daniel Goetzer, who said "SOX was created in haste, but we should not fix it in haste<sup>5</sup>." Clearly, a compromise between the two positions is needed.

## **2.0 What "Scaling 404 Requirements" Means**

"Scaling 404 Requirements" is defined as adjusting the 404 audit approach to make it more economically efficient for small-cap companies. A one-size-fits-all approach to auditing is too expensive for many smaller companies. However, simply imploring auditors to change their approach will not do enough to significantly reduce the costs of 404 audits. Other tactics include guidance, released either by the PCAOB, SEC, FASB, or even private companies and organizations that have experience in satisfying 404 requirements. Any rules or standards released by the PCAOB will help clarify the responsibilities of auditors and suggest more efficient practices. Scaling can come in the form of industry exemptions, new auditing procedures, and the promotion of other internal control frameworks that may be more suitable than COSO. More than anything,

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<sup>4</sup> "SEC Seeks to Ease the 404 Burden" Ken Rankin, 11/27/06

<sup>5</sup> "SEC Seeks to Ease the 404 Burden" Ken Rankin, 11/27/06

scaling 404 is the removal of communication barriers between the players involved. Currently, CPAs generally take a very conservative approach when auditing public companies for fear of not fully complying with 404 requirements<sup>6</sup>. Clients generally just do as they're told by auditors, rather than analyzing themselves and determining what policies, procedures, and internal structure works best for them<sup>7</sup>. Lastly, government agencies, fearful of another accounting scandal, are slow to take the necessary steps to return equality to the auditing environment, even in the face of heavy criticism and soaring costs. If the correct mix of scaling procedures is enacted by all parties involved, some level of equality will return.

### **3.0 The Need for Scaling**

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The crippling effects of Sarbanes Oxley section 404 testing requirements have been felt by numerous entities, including the businesses themselves, investors, and the US capital markets. Since the passing of Sarbanes Oxley in 2002, average costs of 404 audits for smaller public companies are about \$1 million dollars, compared to just \$4 million dollars for large accelerated filers<sup>8</sup>. This is a far cry from the 2003 SEC estimate, which stated that expected costs of implementing 404 would be, in the aggregate, \$1.24 billion, or about \$91,000 per public company<sup>9</sup>. Clearly, the costs of 404 are too high and not evenly distributed. However, it is not just the firms paying these fees that are harmed. Investors, as well as the economy as a whole, have felt the effects and have demanded change.

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<sup>6</sup> “Comments on Proposed Management’s Report on Internal Control Over Financial Reporting” Silicon Valley Leadership Council, 2/26/07

<sup>7</sup> “Comments on SEC Concept Release 34-54122 over Internal Control over Financial Reporting.” American Electronics Association, 9/18/06

<sup>8</sup> “Sized-Based Reporting Standards Needed to Maintain Economy” 3/13/06

<sup>9</sup> “Painful Memories: SEC Grilled on 404 Costs” David M. Katz, 6/12/07

### **3.1 Impact on Small-Cap Companies**

While accelerated filers are generally able to take the hit of the higher-than-expected (but still relatively negligible) costs, small companies generally do not have the resources to handle it. Sarbanes Oxley, which was created as a reaction to the accounting scandals of large corporations such as Enron and WorldCom, has clearly been a much greater inconvenience on small-cap companies. Even though the 3-year average costs for accelerated filers fell 23% from 2004-06 to 2005-07<sup>10</sup>, the costs have still been exponentially higher than anticipated. The fact that these filers are experiencing a disproportionate amount of the effects signals a serious need for change.

### **3.2 Impact on Investors**

In the 5+ years since SOX was passed, investors in American capital markets have been stripped of many of the opportunities to identify star growth-oriented companies, simply because these companies either fear going public due to the cost, or choose to register on foreign exchanges with less stringent oversight. Companies with potential similar to early Starbucks or Microsoft, for example, may no longer have the opportunity to grow and thrive on US exchanges in the post-Sox environment<sup>11</sup>. This loss of potential profitable public companies to invest in can be observed when comparing the NASDAQ and the NYSE to similar foreign markets that have experienced comparable economic, political, and social events as their American peers. An extensive study done at the University of Chicago Graduate School of Business compared the state of the US markets to the London Stock Exchange (LSE) and the Alternative Investment Exchange (AIM), also in London. The authors argue that the four exchanges are

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<sup>10</sup> “How Low Can Sarbanes-Oxley Section 404 Costs Go?” C. de Mesa Graziano and W. Stinnet, 8/20/07

<sup>11</sup> “Sized-Based Reporting Standards Needed to Maintain Economy” 3/13/06



relatively equitable since in the pre-SOX era, the majority of U.S.-based “defectors” chose to list on either the AIM or LSE because of their similarities<sup>12</sup>. While the number of new listings on all four exchanges has declined in the post-Enron era, when controlling for SOX, there is a noticeable trend in small-cap companies shying away from listing on the American capital markets. The UK, realizing the opportunity that the high costs of 404 implementation represented, began heavily promoting the AIM to smaller US companies as a “liquid exchange with strong investor protections”<sup>13</sup>. Ironically, this was one of the attractive features of the NASDAQ before SOX was put into effect. Now, the most appealing feature of US markets has become the credibility associated with listing on a market with stricter regulations, which is an attribute few small firms can afford or are willing to pay for. This conclusion is readily observable when studying the facts. For example, the number of foreign listings on US markets fell 63% in the four quarters following the passing of SOX in 2002<sup>14</sup>. If this drop was due to reasons outside of the Act, then one could expect to see a somewhat similar drop in foreign listings on the LSE. However, in the same time period, these listings doubled<sup>15</sup>. The market that was, for years, considered an alternative for US companies that could not get listed on the NYSE or NASDAQ now appears to be the preferred one. In addition, firms listing on US markets are, on average, less profitable than firms listed on UK markets since the effective date of SOX. However, this loss in profitability is not stratified evenly across all companies. In fact, NYSE-listed companies are about even with LSE firms, meaning that almost all of the loss in profitability occurred in the firms listed on NASDAQ when

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<sup>12</sup> “SOX and the Flow of International Listings” J. Piotroski and S. Srinivasan, 4/07

<sup>13</sup> “SOX and the Flow of International Listings” J. Piotroski and S. Srinivasan, 4/07

<sup>14</sup> “SOX and the Flow of International Listings” J. Piotroski and S. Srinivasan, 4/07

<sup>15</sup> “SOX and the Flow of International Listings” J. Piotroski and S. Srinivasan, 4/07

compared to the AIM<sup>16</sup>. These firms are generally the smaller, less-profitable companies that are looking for a cheap yet safe way to go public. In fact, even after controlling for US companies that likely would have listed on the AIM independent of SOX, the total amount of new market capitalization lost to UK markets, when aggregated, was 21.5 billion<sup>17</sup>. The opposite trend can be seen when looking at companies expected to list on the LSE in the pre-SOX era that have chosen to list on the NYSE instead, which totals about 34.8 billion in market capitalization<sup>18</sup>. Clearly, there is a shift occurring in USA capital markets. For large companies that can more easily absorb the cost of 404 testing, the reputation associated with satisfying the stringent requirements of SOX are worth the costs. However, firms with limited capital and resources clearly do not feel the same way. This means that US investors are slowly being stripped of the opportunity to invest in these small, growth-oriented companies.

### **3.3 Impact on U.S. Economy**

To compound this drawback, the US economy as a whole has felt the effects of the high costs of 404. The share of total global equity raised in US markets, which is a common indicator of relative market attractiveness, has dropped from 28.8% in 2002 to 19.2% in 2007<sup>19</sup>. America, which used to be the clear leader in market attractiveness, has seen a severe drop in the post-SOX years. Listing on a US capital market is becoming little more than a way for foreign firms from countries with weak regulations to provide credibility to their assertions. The attributes that used to make US markets desirable, including liquidity, managerial access to more capital, and lower cost of capital, have

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<sup>16</sup> “SOX and the Flow of International Listings” J. Piotroski and S. Srinivasan, 4/07

<sup>17</sup> “SOX and the Flow of International Listings” J. Piotroski and S. Srinivasan, 4/07

<sup>18</sup> “SOX and the Flow of International Listings” J. Piotroski and S. Srinivasan, 4/07

<sup>19</sup> “The Competitive Position of the US Public Equity Market” Comm. on Capital Mkts Reg., 12/4/07

begun to disappear. From 1996 to 2005, the value of IPOs from US firms listing only on foreign exchanges (in terms of all IPOs from that time) was .1%, while during the first three quarters in 2007, the value was 4.3%<sup>20</sup>. However, US markets are not only losing prospective IPOs. The data suggests that they are also losing companies already listed on them as well. The number of foreign firms delisting from the NYSE in 1997 was 12, or about 4% of all listed foreign companies. By 2006, this number increased to 30 (6.6%), and by October of 2007, the number of companies delisting was at 56, or 12.4%. Not only is there a trend of delisting, but it is growing at an alarming rate. In fact, Tracey Pierce, the head of the LSE's international business development program, stated that "in our discussions with [*US companies listing on the LSE*], the impact of Sarbanes-Oxley is factoring heavily in their decision-making."<sup>21</sup> This significant loss of competitiveness of US markets is summed in Exhibit B. While there is seemingly little doubt about the overreaching effects that the costs of 404 have caused, the solution is not as simple as relieving non-accelerated filers from their obligations to conform with 404 requirements. There is value to be gained, even for small-cap companies, from internal control testing. The question is: How do we balance the need for financial statement transparency with the needs of these companies?

#### **4.0 Necessity of Section 404 for Small-Cap Companies**

The Sarbanes Oxley Act was passed in 2002 with the intent of combating fraud, making financial statements more reliable, and restoring investor confidence<sup>22</sup>.

Obviously, all of these ideas are applicable to small-cap companies as well as large-cap. Investors demand useful, relevant, and accurate information so they can make informed

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<sup>20</sup> "The Competitive Position of the US Public Equity Market" Comm. on Capital Mkts Reg., 12/4/07

<sup>21</sup> "SOX and the Flow of International Listings" J. Piotroski and S. Srinivasan, 4/07

<sup>22</sup> "The Unexpected Benefits of Sarbanes Oxley" Stephen Wagner and Lee Dittmar, 4/06

decisions. The welfare of the American economy depends on these investors making logical choices by allocating capital to the most deserving companies. Even with high costs, the value of data integrity cannot be ignored. Especially now, in times when investor confidence is low, ensuring the integrity of financial information is the ultimate priority. Even though small-cap companies contribute less to the overall health of the economy than accelerated filers do, they still influence it greatly. Financial Executives International's 'Small Public Company Task Force' chairman Richard Brounstein supports this assertion, saying "the U.S. economy depends on smaller companies, particularly for innovation and new-job creation."<sup>23</sup> Therefore, ensuring the integrity of small-company financial statements is necessary to a functioning economy.

#### **4.1 Improvements in Procedures**

While there are some clear benefits for investors in subjecting these companies to 404 testing, including increased financial statement transparency, the companies being tested reap some benefits as well. One survey shows that 404 has made companies more efficient, and employees are now all being held to a higher standard of ethics and are taking more responsibility than before<sup>24</sup>. Yet, in most cases, these qualitative benefits are overlooked. This is most likely due to the fact that it is nearly impossible to calculate the qualitative benefits of a better control environment, while very simple to calculate the costs of an audit. Initial implementation of compliance requirements, a dreaded activity by accelerated filers everywhere, highlighted numerous weaknesses and gaps in company policy that potentially saved these companies millions<sup>25</sup>. For example, when PepsiCo was first required to comply with section 404, they began to document their pension

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<sup>23</sup> "SEC to Revisit 'One Size Fits All'" Stephen Taub, 12/9/05

<sup>24</sup> "How Low Can Sarbanes-Oxley Section 404 Costs Go?" C. de Mesa Graziano and W. Stinnet, 8/20/07

<sup>25</sup> "The Unexpected Benefits of Sarbanes Oxley" Stephen Wagner and Lee Dittmar, 4/06

accounting processes. In doing so, they realized that numerous essential steps, including account reconciliations and data integrity checks, were not occurring<sup>26</sup>. In addition to the elimination of weaknesses, there has been a strong trend among accelerated filers of standardization and consolidation of key financial processes, elimination of redundant information systems, unification of platforms, automation of manual processes, and elimination of unnecessary controls, all related to compliance with 404<sup>27</sup>. It appears that companies are making themselves more efficient and secure simply by complying, which frees up capital and resources to be applied elsewhere. Also, an increased emphasis on the importance of governance has obliged companies to hold employees to higher ethical standards, train them better, and keep everyone within the company more informed on current policies and procedures. Increased process and control documentation, another SOX requirement, clarifies job duties, eases the hiring of new employees, and reduces managerial override<sup>28</sup>. Small-cap companies can especially benefit from up-to-date job descriptions and process documentation in times of employee turnover. Since processes are generally less formalized in these companies, the damage from losses of key employees can be minimized by proper documentation, and less key information lost with the departure of the employee.

#### **4.2 Improvements in Audit Efficiency**

Efficiencies borne from 404 compliance can actually make other parts of the audit go smoother and quicker, reducing fees in those areas. Within companies, historical practices exist that provide opportunities for fraud and error. At Sunoco, there existed an invoicing system that resulted in four unique billing processes, one for each product

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<sup>26</sup> “The Unexpected Benefits of Sarbanes Oxley” Stephen Wagner and Lee Dittmar, 4/06

<sup>27</sup> “The Unexpected Benefits of Sarbanes Oxley” Stephen Wagner and Lee Dittmar, 4/06

<sup>28</sup> “The Unexpected Benefits of Sarbanes Oxley” Stephen Wagner and Lee Dittmar, 4/06

category. These differences were not based on logic; rather, they arose purely out of industry tradition. As a result, they changed to a single billing process, which greatly reduced the chance of error in the billing process, and reduced the number of costly re-bills<sup>29</sup>. Thanks to this improved invoicing system, the auditors had more confidence in the accuracy of their client's receivables, resulting in less testing. Sunoco is by no means alone in this regard. There are numerous examples, some recognized and others not, of 404 improving the efficiency and security of public companies, and small-cap companies should not be denied these benefits.

## **5.0 How To Scale the Requirements of 404**

In order to allow small-cap companies to enjoy the benefits of 404, the disproportionately high costs must be mitigated. Barring a complete overhaul of Sarbanes Oxley within the next few years, which is highly unlikely, the only feasible solution to this problem is to scale the testing requirements for these entities. After researching numerous suggestions from all sides of the argument, I have compiled a system that I believe will lower the costs in the long run without damaging the integrity of the financial data. There are three preparatory actions that can be taken to ensure that these small public companies are ready to deal with 404 testing requirements when they are finally required to comply with them. These actions are the issuance of specific guidance about compliance, the passing of new rules or standards, and industry exemptions. Then, a system of rotational audit procedures can be enacted to lessen the annual burden on small companies. Together, these four suggestions have the ability to greatly reduce to potentially devastating costs of section 404 compliance.

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<sup>29</sup> “*The Unexpected Benefits of Sarbanes Oxley*” Stephen Wagner and Lee Dittmar, 4/06

## **5.1 Guidance**

By nature, small public companies have different internal structures than large corporations. Due to a smaller workforce, segregation of duties is frequently not feasible. In addition, less procedure and policy standardization muddles responsibilities and allows more subjectivity in decision-making. Small companies tend to rely more on daily interaction of upper management than would normally be seen in a larger company, where such constant oversight is impossible. Due to these unique internal control attributes, specific guidance on how to successfully comply with 404 requirements in a small-company setting is necessary. While there exist numerous guidance manuals already, an all-inclusive, example-laden release is necessary to clarify what is expected from these companies when the auditors begin 404 testing. In previous guidance issuances, specific examples have not generally been offered, which has led to confusion on the part the companies, and overly-conservative auditing procedures on the part of the CPAs. Suggestions about how substantive tests should be affected in relation to a weak, moderate, and strong control environment would also be helpful for clients and auditors alike<sup>30</sup>. One non-accelerated filer, Tandy Leather Factory, has an accounting department of only 16 people, and only 2 of them have college degrees<sup>31</sup>. It is not reasonable to assume companies such as this one will accurately and efficiently update their internal control structure and documentation simply by following general advice. In addition, the guidance should be more principles-based. With the passing of SOX, auditors have begun to rely on a ‘checklist’ approach, rather than analyzing the unique situations of the

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<sup>30</sup> “*Comments on Proposed Management’s Report on Internal Control Over Financial Reporting*” Silicon Valley Leadership Council, 2/27/06

<sup>31</sup> “*What the 404 Delay Means for Small Companies*” Sarah Johnson, 12/12/07

entities<sup>32</sup>. The costs associated with not fully satisfying SOX testing requirements are so great, non-efficient and non-effective procedures have become the norm to decrease liability. Sufficient guidance, in association with other scaling policies, may help to ease to confusion and fear of both small companies and auditors alike, making the process cheaper, more efficient, and more beneficial.

### **5.2 New Rules and Standards**

On July 7, 2007, the SEC approved the PCAOB's adoption of Auditing Standard 5 to replace Auditing Standard 2. The new Standard is considered to be a simpler, more principles-based version of A/S 2 intended to encourage a "top-down, risk-based audit approach."<sup>33</sup> A/S 5 eliminated several unnecessary procedures, such as requiring auditors to opine on the opinion issued by management pertaining to their own internal controls<sup>34</sup>. Also, included in A/S 5 is the recognition that small public companies "may have less complex operations... more centralized accounting functions, extensive involvement of senior management in the day-to-day activities of the business, and fewer levels of management."<sup>35</sup>

While the new Standard is a good first step, more rules are needed to address current weaknesses in policy. One such rule should encourage small companies to emphasize the importance of Board involvement and competent governance. If small-cap companies are required to have a more active Board and stricter corporate governance policies, auditors will on the whole have greater confidence in the effectiveness of

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<sup>32</sup> "Comments on SEC Concept Release 34-54122 on Internal Control over Financial Reporting." American Electronics Association, 9/18/06

<sup>33</sup> "Coming This Summer: 404 for All" Alan Rappeport, 6/5/07

<sup>34</sup> "Auditing Standard Number 5" PCAOB, 7/27/07

<sup>35</sup> "Auditing Standard Number 5" PCAOB, 7/27/07



internal controls. This means compliance costs could be significantly reduced since less control and substantive testing will be required<sup>36</sup>.

The rules related to the restatement of company financials must also be addressed. Many times, restatements pertain to a difference in opinion between auditors and the firm relating to a complex transaction rather than an obvious error, oversight, or fraud<sup>37</sup>. In addition, a Government Accountability Office study in 2006 discovered that 53% of restatements had a net effect of less than 1% on company market value<sup>38</sup>. Restatements are only supposed to be issued when the change is expected to have a material effect on the investors' decisions. Yet, in 53% of restatements, investors do not seem to react at all. This exposes a trend of conservative auditing, due to the fact that auditing is a practice with limited gains, yet unlimited liability<sup>39</sup>. Clearly, this is a situation where even though the marginal benefits of issuing restated financials are greater than the marginal costs, they occur anyway<sup>40</sup>.

### **5.3 Industry Exemptions**

While all public companies can benefit from more efficient internal controls, there are some specific industries where 404 compliance has little value. The two industries with the strongest arguments for exemption are biotech and community banking. In the field of biotechnology, the majority of resources are devoted to research and development of medicines intended to save lives and improve quality of life. The amount of resources

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<sup>36</sup> “*The Unexpected Benefits of Sarbanes Oxley*” Stephen Wagner and Lee Dittmar, 4/06

<sup>37</sup> “*Comments on SEC Concept Release 34-54122 on Internal Control over Financial Reporting.*” American Electronics Association, 9/18/06

<sup>38</sup> “*Comments on SEC Proposed Rule: Management’s Report on Internal Control Over Financial Reporting*” Committee on Capital Markets Regulation, 2/26/07

<sup>39</sup> “*Comment on the Proposed Delay of 404 Compliance Requirements for Small Companies*” International Association of Small Broker Dealers, (undated)

<sup>40</sup> “*Comment on the Proposed Delay of 404 Compliance Requirements for Small Companies*” International Association of Small Broker Dealers, (undated)

diverted away from research in order to comply with 404 requirements can have detrimental effects on work being done. Also, since many biotech firms survive on the backing of venture capitalists, they may lose funding to more profitable industries.

The community banking industry should also be considered for an exemption from complying with 404 requirements. In 1991, the FDIC passed the FDIC Improvement Act, forcing banks to evaluate their internal controls. The main difference is that the results of the analysis are not publicly viewable. Industry advocates claim that FDICIA has already solved the internal control issues in the banking industry, citing the sharp decline in bank failures since the passing of the Act<sup>41</sup>. Even Rep. Michael Oxley, co-author of the Sarbanes-Oxley Act, was quoted as saying that if he had to do it again, he would have “eased up on the banking industry.”<sup>42</sup>,

If complete industry exemptions are deemed too severe, a compromise could come in the form of shareholder approval. Larry Ribstein, a law professor at the University of Illinois and co-author of the book *The Sarbanes-Oxley Debacle: What We’ve Learned; How to Fix it*, suggests allowing the shareholders of companies in industries such as community banking and biotechnology to vote on foregoing 404 compliance. This way, companies with strong internal controls and competent management will be rewarded with more capital and resources.

#### **5.4 Rotational 404 Audits**

The solution that could potentially have the greatest effect on cost reduction would be rotational 404 audits. Once again, I utilize the idea of allowing shareholders to determine the value of 404 compliance. Before I continue, an outline of the Silicon

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<sup>41</sup> “Next From SarBox: Industry Exemptions?” Jabulani Laffall, 7/21/06

<sup>42</sup> “Next From SarBox: Industry Exemptions?” Jabulani Laffall, 7/21/06

Valley Leadership Group's suggestion for a rotational audit scheme is provided in Exhibit A for clarification<sup>43</sup>. If a non-accelerated filer successfully completes an audit without any material weaknesses being found, their shareholders will be allowed to vote on whether or not they want to install a three-year rotation of internal control testing, starting with the previous year. If the shareholders approve the reduced testing, auditors will go ahead in year two and reduce their testing of internal controls. All internal controls deemed 'fundamentally paramount' by the auditors will be tested in full each year, and management will still be required to opine on all internal controls each year. However, only 50% of low-risk internal controls will be tested in year two. Then, in year three, 50% of low-risk internal controls will again be tested. It should be noted that these are not necessarily the 'other' 50% of internal controls that were not tested in year two. In years two and three, a random selection technique should be utilized to select which controls are going to be tested that year. This way, clients will not be able to know which controls will not be tested in a given year, lowering the possibility of managerial override or fraud relating to a specific control. Also, the 50% of low-risk internal controls is not binding. Before the selection of controls to be tested is made, the auditors will perform preliminary auditing procedures including walkthroughs, inspection of records, and observations to identify any new controls put in place, or areas where key personnel have changed. These controls will then automatically be tested. Then, in a meeting with management, any specific low-risk control they wish to be tested will also be tested, given the reason provided by management is deemed acceptable.

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<sup>43</sup> "Comments on Proposed Management's Report on Internal Control Over Financial Reporting" Silicon Valley Leadership Council, 2/27/06

This process can be immediately halted in two ways. If, during the annual vote, the shareholders opt to revert back to a full audit, the rotation stops and a normal audit will occur. Also, if a material weakness is discovered by the auditors, a complete control audit will begin immediately. A pervasive material weakness is described as “more than one material weakness or multiple significant deficiencies involving a pervasive breakdown in controls.”<sup>44</sup> Then, in the following year, a full 404 audit, free of material weakness, must be achieved before shareholders will be given the opportunity to vote again for the subsequent year.

It is my belief that allowing the shareholders to vote permitting a rotational 404 audit scheme allows the owners of the company to determine whether or not full compliance for small-cap companies has value. This sentiment is echoed by numerous small business advocacy groups, such as the American Electronics Association<sup>45</sup>. By allowing the financial markets to determine the value of 404 compliance, the decision is put in the hands of those affected most by the requirements.

However, pushing through such a drastic change would take much compromise and cooperation between numerous parties and stakeholders. First, the laws related to auditor liability would have to be revised. Since auditors would no longer be in complete control of what was being tested, they should not have to accept the same responsibility that they would if they were able to plan a full audit. Instead, management should take on the additional responsibility since they still must opine on the fitness of all internal controls, even if they will not all be tested.

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<sup>44</sup> “*Comments on Proposed Management’s Report on Internal Control Over Financial Reporting*” Silicon Valley Leadership Council, 2/27/06

<sup>45</sup> “*Comments on SEC Concept Release 34-54122 on Internal Control over Financial Reporting.*” American Electronics Association, 9/18/06

In addition, rotational audits, whereby stockholders vote to reduce testing, do remove some amount of auditor judgment that was gained with the release of AS/5. Giving this up would be a hit to the auditing community, yet a necessary one for the sake of the U.S. economy. Also, banks may not feel the amount of testing from rotational audits is satisfactory to continue to lend money. However, this should be considered by the stockholders before their vote on the audit. If the banks make it apparent that they will call loans if rotational audits are approved, the stockholders may want to consider full compliance.

Clearly, there are numerous issues that require large amounts of cooperation that must be worked out before such a system could be put into place. However, as more and more time passes, small-cap companies will continue to look elsewhere for opportunities to raise capital. The next ten years will show whether or not the US is truly affected by the loss of these companies, or if the gain in large internationally-listed companies is satisfactory compensation<sup>46</sup>.

## **6.0 Concluding Remarks**

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The Sarbanes Oxley Act was created as a response to a loss in investor confidence relating to the numerous accounting scandals that occurred in 2002 and the few years preceding. Now, more than five years have passed, and costs and benefits are starting to be understood. The most prevalent issue that arose has been the astonishingly high costs of complying with section 404, and how these costs are exponentially higher for small public companies. Since these entities were not the primary “targets” of the Act, there has been a call to scale the costs related to complying with section 404 so all public companies are affected equally by the Act. By implementing any or all of these

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<sup>46</sup> “SOX and the Flow of International Listings” J. Piotroski and S. Srinivasan, 4/07

suggestions, the costs can be incrementally reduced with little to no reduction in investor confidence in the integrity of financial data. And, if the financial markets determine that a rotational audit scheme does in fact lower investor confidence in the control environment of the companies, a mechanism is built in to return to a full 404 audit scheme. While too many qualitative factors may prevent us from ever identifying the true value of the costs and benefits of 404 testing, the decision of whether or not to comply should at least be in the hands of those stakeholders most affected by them.

## Exhibit A<sup>47</sup>

Status	Events & Triggers	Audit Type	
		External	Internal
Year 1	Clean Opinion.	Full Scope Audit.	Full Scope Audit.
Year 2		Full Scope Audit for 1/3 of Companies, Based on a Rotating Schedule; Attestation and Management Certifications to Correspond.	Rotation of key control testing based on risk assessment.*
Year 3		Full Scope Audit for 1/3 of Companies, Based on a Rotating Schedule; Attestation and Management Certifications to Correspond.	Rotation of key control testing based on risk assessment.
Year 4 +		Cycle continues.	
Any Year - Isolated Material Weakness	<i>Isolated Material Weakness:</i> Limited to a single functional area or financial statement line item. (e.g., tax process or A/R financial statement line item).	Limited Scope Audit.	Full examination audit of key controls related to process or financial statement line item where material deficiency occurred. Rotation of key control testing based on risk assessment.
Any Year - Pervasive Material Weakness	<i>Pervasive Material Weakness:</i> More than one material weakness or multiple significant deficiencies involving a pervasive break-down in controls (e.g., personnel hiring / staffing deficiencies or pervasive lack of appropriate reconciliations or management reviews).	Full Scope Audit.	Full Scope Audit.
Plus - 1 Year (repeat cycle above)	Clean Opinion.	Full Scope Audit.	Full Scope Audit.
Any Year - Material change in entity-wide controls over financial reporting	For example, major changes in key company personnel or an ERP implementation.	<i>Full or Limited Scope Audit</i> , based on risk assessment. If change or factors could have a pervasive impact on processes and/or financial statement accounts, then full examination is called for.	<i>Full or Limited Scope Audit</i> , based on risk assessment.

<sup>47</sup> “Comments on Proposed Management’s Report on Internal Control Over Financial Reporting” Silicon Valley Leadership Council 2/26/07

**Exhibit B<sup>48</sup>**

**SUMMARY OF COMPETITIVE MEASURES**

<b>Measure</b>	<b>Historical Average</b>	<b>2007</b>	<b>Improvement/ Decline</b>
U.S. Share of Equity Raised in Global Public Markets	1996-2005: 33.2%	22.0 %	Worse
Global IPOs by Foreign Companies (By value) on U.S. Markets	1996-2005: 30.9%	7.7%	Worse
Largest Global IPOs on U.S. Markets	1996: 8 / 20	0 / 20	Worse
IPOs of U.S. Companies Abroad	1996-2005: .1%	4.3%	Worse
Cross-Listings in U.S. by Foreign Companies	2000-2005: 21	4	Worse
Foreign Delisting Rates on the NYSE	1997-2005: 5.2%	12.4%	Worse
U.S. Share of Global Market Capitalization	1990-2005: 43.6%	35.2%	Worse
U.S. Share of the Value of Global Share Trading	1990-2005: 50.7%	41.2%	Worse

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<sup>48</sup> “*The Competitive Position of the US Public Equity Market*” Comm. on Capital Mkts Reg. 12/4/07



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